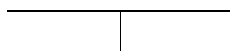
PICTET
Asset Management

International Equity - EAFE

An Owner's Manual

Pictet Asset Management, November 2018



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Introduction

We would like to begin by thanking our existing investors for the trust and faith they have placed in us. Many have been with us for many years, if not decades, and we hope to continue delivering on that trust in the future.

For those less familiar with Pictet AM's International Equity - EAFE strategy and team, we hope this document provides a clear introduction to how we invest - our guiding beliefs, and the way they steer what we do (and just as importantly, don't do) on a day to day basis.

We believe achieving superior long-term returns from equities depends on the disciplined application of a sound investment approach. At the same time we should be clear that we don't believe an investment approach can be all things to all people. By definition we must be meaningfully different from the average investment manager, and demonstrate skill in what we do to achieve above average results. However, the path to 'above average' over the long term is rarely a smooth one. Over shorter periods, returns can sometimes be 'meaningfully below average'.

> **"THE PATH TO 'ABOVE AVERAGE' OVER THE LONG TERM IS RARELY A SMOOTH ONE."**

This document, then, has a dual purpose. It should serve as a reminder of our investment philosophy and process. And it should also be used to hold us to account. To put it simply, if we act in a way that is inconsistent with what we set out below, clients should challenge us in the strongest possible way.

So, to our beliefs, process, what you should expect from us, and what you shouldn't...

How you should expect us to invest

Our goals

- Deliver superior investment returns to our clients over the long term, namely five years and over.
- Execute on our process and philosophy in a diligent manner.
- Create a relationship of trust and understanding with our clients.
- Behave with the upmost honesty and integrity.

Stocks represent fractional ownership of a business

For many fund managers, stocks represent tickers on a screen: highly volatile instruments in which one can invest (or 'speculate' is perhaps more appropriate) on the promise of a quick return. This 'gambling tendency', as coined by behavioural psychologist Daniel Kahneman, is hardwired into the psyche of most people whether they admit it or not. We view things quite differently.

We equate buying a stock to buying out a *whole* business, but in a way that avoids the frictional costs and takeout premium, and then the hassle of running the business. To that end, we try to identify competent management teams that will do this day-to-day hard work for us. To put things into perspective, the price of average stocks quoted in developed international markets will typically have an annual peak to trough decline of around 50 percent[1] relative to a long-term compound rate of real return for equities of around eight percent[2]. So, stocks are volatile, businesses far less so. With this in mind, when we buy into a stock we often ask ourselves, 'can we see ourselves retaining this investment for the next five years?' In answering this question, we find ourselves discarding a lot of the potential investments we look at.

"WE PREFER EASIER QUESTIONS THAT FOCUS ON FACTORS A COMPANY CAN CONTROL."

Because we see ourselves as business owners, we do not spend a lot of time attempting to gauge or forecast macroeconomic factors such as GDP growth rates, currency or commodity movements, trade balances or inflation. Many of these factors are just too difficult to assess with any conviction, and sit outside our skill set. We prefer easier questions that focus on factors a company can control. What is more, we have found only a limited correlation between many of these factors and equity market returns over time. For example, in the case of currency one would observe a low (frequently negative) correlation between returns from a currency and returns achieved by foreign investors from equities denominated in that currency[3]. The reason is that many companies are 'naturally hedged' through their revenues and costs.

A long-term horizon is perhaps the single biggest advantage an investor can have today

Most investment managers believe that information gives them an edge.

The emphasis is on speed and breadth. Trying to be the first to understand whether an earnings release constitutes a 'beat' or a 'miss' relative to consensus, and to act on it; or modelling a large conglomerate business on a division or even sub-division basis and missing the 'wood for the trees'. We do not view information as a source of competitive advantage. Instead, we focus heavily on the other two sources of investment success: process and behaviour.

"WE FOCUS HEAVILY ON THE OTHER TWO SOURCES OF INVESTMENT SUCCESS: PROCESS AND BEHAVIOUR."

The average investment we make will be held for around five years, this compares with a market average of four months today[4], and less than a year for the average mutual fund manager[5]. We believe the investment management industry is becoming increasingly short-term, with algorithm-based transactions materially shortening average holding periods. Therefore, we think it makes sense to lengthen one's time horizon as others shorten theirs. We believe the market's increasing short termism should lead to inefficiency over longer-term horizons, not in information, but in behaviours from which we aim to take advantage.

[1] Average EAFE Index company stock price range (lowest closing price / highest closing price) in the five calendar years to end 2017 was 49 percent. Source: Bloomberg, Pictet Asset Management.

[2] CIBC Wood Gundy – 'Perspectives' – Volume 6 – Issue 3

[3] GMO Quarterly Letter to clients, Q2 2018

[4] NYSE statistics

[5] NYSE statistics

As we suggest in the introduction, there are challenges associated with taking a long-term view.

First, one needs to operate in a working environment that embraces a long-term approach.

We are fortunate in this respect. The Pictet Group is a private partnership with a history in asset and wealth management dating back to 1805. 'Long-term' is far more than a buzzword for the group; it's deeply ingrained in the culture. If the latter is critical, it is equally important to ensure that we attract clients who share our objectives and time horizon. We try to be as clear as possible from the outset that we do not expect to outperform every quarter or year, or even over every three-year period, but over five+ year time horizons. We have proven to do consistently well relative to markets over that time horizon, and this is what we hope to continue achieving.

The second major challenge with being long-term is the problems inherent in forecasting. The future is difficult to predict with any precision. Business is rarely linear. Indeed the average age of companies listed in the US has fallen from nearly 60 years in the 1950s to under 20 years today[6]. The revolution in technology means that businesses are coming and going at an unprecedented rate. In this constantly changing environment, the wild fluctuations of stock prices often allow a disciplined and patient investor, such as ourselves, to buy part of a good business with such a significant margin of safety it offsets the inevitable errors we will make in attempting to forecast the future.

Cash-flow takes primacy over earnings or balance sheet based metrics in our analysis

We prefer cash flow to earnings or balance sheet metrics for a few reasons. Firstly, cash flow encourages us to focus on dynamics which are smoothed out by accrual accounting conventions used in reported earnings. Secondly, it's a great way to spot potentially fraudulent behaviour. Enron were famous for being 'laser focused' on EPS growth for example. Accruals are a great way to window dress an otherwise faltering business. Balance sheet metrics are also flawed in our opinion. Gone are the days when a business has to double its asset base to grow its intrinsic value by the same amount. Some of the greatest businesses in fact require almost no incremental capital to grow but also possess truly impenetrable economic moats.

[6] Credit Suisse study, 2017

Return on capital is the lens through which we consider business quality and growth opportunities

We look for businesses that have the ability to deliver high returns on capital over time. This approach differs meaningfully from a focus on growth. Growth is exciting, it is often tied to a theme or fad that if linearly extrapolated, can promise low valuations in the future. What is empirically proven, however, is that growth, as measured by growth in revenues, typically does not last[7]. Within five years it tends to revert to a normal level through competitive forces or simply the base effect.

Furthermore, growth does not equal economic profit. Several industries have grown dramatically and changed our way of life. Think for example about autos or semiconductors. However, competition has typically eroded the profit of these industries making them a minefield for investors.

> **"WE LOOK FOR BUSINESSES THAT HAVE THE ABILITY TO DELIVER HIGH RETURNS ON CAPITAL OVER TIME."**

Instead, we focus on returns. High returns on capital are typically a function not of growth in an industry but of a favourable competitive environment. Far less exciting a topic for many but also proven to be more enduring[8]. There are several sources of competitive advantage which can lead to sustainably high returns but can broadly be broken down into three categories: a cost advantage such as a low resource cost; customer captivity such as high switching costs; and scale advantages such as network effects.

We believe return on capital is a good indicator to judge management. Growth can quite easily be engineered over short periods of time through heavy investment. Think of the numerous companies over the years that have grown through acquisition sprees on the basis of earnings accretion. However, over time, the growth of a business will tend towards its return on capital as the total capital employed mirrors these investments. We prefer to see management who emphasise strong and improving returns on each project they embark on rather than growth.

[7] "Valuation – Measuring and Managing the Value of Companies." Koller, Goedart and Wessels (KcKinsey & Company). 6th Edition, 2015

[8] "Valuation – Measuring and Managing the Value of Companies." Koller, Goedart and Wessels (KcKinsey & Company). 6th Edition, 2015

Importantly, we do not rely on historical returns as the basis for this assessment. Several companies in the portfolio will be earning below-par returns but our analysis will indicate that these returns will change - either through a change in the business or a change in the competitive environment.

The intrinsic value of a business drives our decision making

Although the portfolio does not fall under the traditional classification of 'value' such as low price-to-earnings or price-to-book, our decisions to buy and sell and those concerning size of investment are largely a function of our assessment of the intrinsic value of a business. The way in which we value businesses is based on free-cash flow and the amount which can be produced by a company over its life. Importantly, our approach to this is absolute rather than relative. To be more specific, our hurdle rate for a given business will be between five percent and ten percent per annum at our intrinsic value. When coupled with the margin of safety we look to achieve through both business quality and a discount to this intrinsic value, we hope to be able to deliver good returns to our clients above and beyond the relevant benchmarks.

Our quest for high risk-adjusted returns over the long term will not be jeopardised by greed for more assets

One weakness in the asset management industry is the frequently strong incentive for participants to chase an incremental dollar of revenue even though this risks damaging long-term returns, thus growing a successful strategy to the point that future performance is compromised by problems associated to scale, specifically liquidity.

This is particularly a risk for our strategy. We have a benchmark and market cap agnostic approach, and have historically added value through investments in mid and smaller companies. We want to retain this flexibility in the future. Our track record would be worth little if client assets grew to a level that meant we could no longer do this. Our commitment to our clients is clear: we will not prioritise assets growth over long-terms returns.

Portfolio management team

Pictet AM's International Equity - EAFE strategy is currently co-led by Fabio Paolini and Benjamin Beneche who have been working together on the strategy since 2012.

The portfolio managers are supported by a team of eight investment analysts and a senior product specialist, Charles Price.[9]

Benjamin Beneche, Co-Lead Portfolio Manager

Benjamin Beneche joined Pictet Asset Management in 2008 and is a Senior Investment Manager. He co-leads the firm's International Equity - EAFE strategy with Fabio Paolini.

Benjamin graduated from York University with a first-class honours degree in Economics and Economic History. He also holds the Investment Management Certificate (IMC) and is a Chartered Financial Analyst (CFA) charter holder.

Fabio Paolini, Co-Lead Portfolio Manager

Fabio Paolini joined Pictet Asset Management in 1997 and is Head of the Greater European Equities Team. He also co-leads the firm's International Equity - EAFE strategy with Benjamin Beneche and is an Equity Partner of the firm.

Fabio started his career in Pictet's Financial Research department in 1994, initially in the Economics team and then in the European equities research team.

Fabio graduated with a degree in Economics from the University of Siena in Italy. He obtained a CFPI/AZEK diploma in 1996 and is a Chartered Financial Analyst (CFA) charter holder.

[9] Portfolio management team information as at 30.09.2018

Document issued by:

Pictet Asset Management Ltd
Moor House, Level 11
120 London Wall
London, EC2Y 5ET
United Kingdom

Document distributed by:

Pictet Asset Management Inc.
1000, Rue de la Gauchetière West
Suite 3100
Montreal – Quebec H3B 4W5
Canada
Tel: +1 514 288 8161

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